I was a principle author of the paper, <u>Defining the Universal Service Affordability Requirement</u> that forms the basis for Time-Warner Communications proposal to the FCC for consideration of community income as a factor in universal service support.

ETI's analysis of the relationship between income and high cost support was an outgrowth of our detailed analyses of the various cost proxy models that were first presented to the Commission in 1996.

One thing that struck us was the fact that the models that purported to target support on the basis of high cost, also directed support to many well to do communities where customers clearly could afford to pay for the entire cost of their local telephone service without any subsidy whatsoever. Further research demonstrated that this was not an isolated condition. It was a nationwide pattern.

ETI's analysis demonstrated that a decision not to fund support to high income CBG's would result in a significant reduction in the overall size of the interstate high cost fund.

The Telecommunications Act of 1996 explicitly requires that affordability be included as a consideration in the development of a comprehensive universal support mechanism. Quality services should be available at just, reasonable and affordable rates.

The extent to which services affordable to an individual customer inextricably linked to that consumer's income level and ability to pay. And in fact, the Joint Board, in its recommended decision, and the Commission, in its report and order, have acknowledged that income level directly effects the determination of what is an affordable price.

The Commission has also agreed that community income, as represented by the percentage of students eligible for school lunches is a valid basis for establishing the variable discounts necessary to make telecommunications affordable to schools and libraries.

The universal service goal is not advanced by subsidizing consumers who can afford to pay the entire cost of their telephone service and whose decision to take services unaffected by the presence of such a subsidy. Indeed, some of the specific attributes of exclusive high income communities, large lots, low population density, remoteness from primary population centers are the very same conditions that tend to raise the cost of providing local telephone service.

Ironically, many low income areas, such as densely populated, inner-city communities are, because of such attributes, also low cost areas, and could well be forced to subsidize the high rent, high cost to serve suburbs.

Policies that would flow universal service support to high income communities serve only to impose significant costs and economic burdens upon other segments of the company, while doing nothing to advance the cause of universal service or produce any other offsetting economic or social benefit.

Among other things, a funding obligation that is larger than one that is minimally necessary to achieve the universal service goal will undermine other Commission and Congressional objectives, perhaps, even including universal service itself by forcing new entrants to make larger than necessary payments to the universal service funding mechanism, such policies will increase the costs of and barriers to, competitive entry, and thereby diminish the prospects for effective competition overall.

They will also work to suppress demand for price elastic services, thereby limiting the potential benefits that all sectors of the economy can derive from increased access to and use of the nation's telecommunications resources.

The ETI study and Time-Warner's proposals are not offered as providing definitive or prescriptive guidance as to how structure an income-based funding mechanism. Rather, it is offered to demonstrate that many high cost communities are also high communities. That public data is available from the Census Bureau to support the administration of a community income-based funding mechanism. And that there is an opportunity to achieve a significant decrease in the overall size of the universal service support fund fully consistent with the statutory requirement that service be affordable without any consequential impact upon the overall universal service goal.

The structure of community income-based funding mechanism should be built upon three specific policy initiatives. First, the FCC and the states should conclude that the highest income, high cost areas are to be excluded from universal service support. For example, if all CBG's with median -- time is up. Shall I wrap this up?

CHAIRMAN KENNARD: Please.

MS. BALDWIN: If all CBG's with median income levels in the top 30 percent of their state were placed in this category, the funding requirement could be reduced significantly by as much as 20 to 30 percent. Second, there should be a safety net for low income consumers residing within high income, high cost areas who cannot afford to pay full cost based rates. And third, to avoid rate check, transition plans should be established that would allow carriers to move rates in high cost, high income carriers to their full forwarding looking costs.

If it's done correctly, and it can be done correctly, the result will be a win-win for all. Thank you very much for the opportunity to present these comments today.

CHAIRMAN KENNARD: Thank you, Ms. Baldwin. Mr. Weller?

MR. WELLER: Good morning, Mr. Chairman. My name is Dennis Weller. I'm chief economist at GTE.

I've take the liberty of preparing a chart, which is in your materials, to help you follow the money. It shows, basically, an overview of where the money is coming from and where it's going to within GTE-serving areas in 28 states today.

The chart shows contribution by major service category. And basically, what this is showing you is that you have very large contributions from interstate access and from other state rates, which makes it possible to fund a very large negative contribution from residents local service.

For comparison, I've provided another set of rates on the chart which shows what rate these category contributions would like if rates were re-balanced on the basis of a constant percentage mark-up over the direct cost of each service. The difference between the two bars gives you a measure of the intervention, basically, that's been performed by regulation, and also, where the money is flowing in and out of each one of these service categories today.

Now, there are several observations I think we can make based on this chart. First, debates about large or small fund sizes, I think, are moot. We already have a large fund. It's on the chart. It's in our rates.

Second, only a very small portion of this funding today is implicit. The very small black foot that you see on the left most set of bars, is the explicit support that GTE gets from the high cost fund today.

And third, if we use the consistent methodology with respect to both rates and costs, we should be able to look at either end of this chart and get a consistent answer. In other words, we should be able to add up what local is receiving in support or add up what the other services are providing in excess contribution and get a consistent answer.

In other words, this is a price system that has to add up. The only way to avoid that is to ignore part of the chart -- some of the bars, or to assume a completely different cost level.

Now, why can't we keep on doing this? What's wrong with this picture? Well, the first thing is we can forget about local competition if we keep doing this. I mean, look at this contribution for residents local here.

Who wants to enter this market? Nobody does. And the support that comes from the other services implicitly can't be made portable for someone who tries to serve one of these customers. Particularly, if they are low usage customers, which the majority of them are because the distribution of usage is highly skewed. So, that's point number one.

You're right, Commissioner Ness, though. The customers are protected. But they're also protected against competition if we don't do something about this.

And the second thing, as the Chairman noted, is the competition will, ultimately, erode the sources of implicit support. So, what should we do about this? Well, first, I recommend that the Commission should establish a program that's based on three objectives.

The first is, that the fund should be sufficient to replace the implicit support that's coming from interstate access today. That's the left-most bar. It's unreasonable to expect that any state action will address that part of the problem. My calculations show that that's about $6.3 billion at current levels.

Second, the fund should provide a reasonable amount of support for states with high cost and/or very low funding basis. This, obviously, has to be balanced with the interest of other states.

And third, as several people have mentioned, the fund should do no harm. That is, it should provide at least as much support. It should, essentially, replace the support that comes from current explicit fund.

How would I recommend that we go about that? I propose that the Commission follow the same basic benchmark methodology that it's already adopted, but use an array of benchmarks, which I refer to as a sliding scale. Several benchmarks -- you need several benchmarks to hit the several policy targets that you have. I don't think that you can do it with just one. With increasing percentages of support above each benchmark, I've provided examples and illustrations of this in our comments and in the package in front of you. I won't go into details here.

The point is that there's no benchmark that's perfect a priori. A good benchmark is a benchmark that gives a good answer. That's why I've held up in front of you objectives to hit. And the exercise I have in mind is that you adjust the benchmarks until you hit the target. If the benchmarks don't hit the target, you go back and adjust the benchmarks. Obviously, to do this properly, you have to decide on the cost model of the inputs first, otherwise you have no idea of what effect the cost models and the inputs will have.

Finally, the cost models are necessary, as Commissioner Wood noted, but they're also unreliable. And that's why it's important to have externally measurable goals that you can judge the reasonableness of the outcome against. If the outcome isn't reasonable, than the model isn't reasonable.

Now, how would all this be funded? I propose -- well, first let me stop and say, this is a good way of getting the initial level of support in January. But after that, I think that a process of competitive bidding would provide a way of correcting these amounts if they are wrong and also adjusting them over time.

Finally, I recommend that this program be funded by a uniform percentage surcharge on both state and interstate rates. I estimate that it would take about a three percent surcharge to do that. Rather than have wildly inconsistent tax rates on different people -- some people paying several hundred percent today through the rates on this chart, I think it's more fair, more competitively neutral and more efficient to have everyone pay three percent.

And finally, if we do that, for the first time, carriers will be able to come into local markets and serve these customers and find them a reasonable proposition, which they cannot do today. Thank you, Mr. Chairman.

CHAIRMAN KENNARD: Thank you, Mr. Weller. Before we move on, I wanted to introduce and acknowledge one person who's here today. I'm not sure how long she's going to be here, so I wanted to recognize her briefly. And that is Kathy Brown is going to be joining us next week as Chief of the Common Carrier Bureau. She will be leaving her job as associate administrator at the National Telecommunications and Information Administration.

And Kathy has already rejected some advice that I gave her. I advised her to take some time off between jobs, but Kathy decided that she would rather be here with us. So, I think that's some measure of her commitment to the challenge that she's taking on. Kathy will be playing, obviously, a major role in grappling the issues that we're discussing today. So, we're delighted that you're here. Thank you.

Mr. Bush?

MR. BUSH: Thank you, Mr. Chairman. Good morning. My name is Ernest Bush. I'm Assistant Vice president of Federal Regulatory for Bell-South Telecommunications. On behalf of Bell-South, I would like to thank you for the opportunity to appear before you today to share my company's views on the critical issues of high cost support in universal service.

As we all know, it's a critical issue and a complicated one, but one that is literally vital to the constituents we all serve, the American public.

In the Telecommunications Act of 1996, Congress incorporated language laying out the requirements of the universal service program. Clearly, Congress was concerned about preserving the availability of high quality telecommunications services in all regions of the country. Obviously, any universal service plan adopted by the Federal Commission or the state commissions must address this concern.

However, a more subtle point grows out of the impact universal service support has -- universal service support and funding obligations has on the development of competition within the local exchange marketplace.

It should be no surprise that my company is concerned about the existence and level of implicit subsidies built into our access and business rates. And we are also concerned and believe others are as well, about the impact that subsidized rates have on the development of a competitive residential marketplace, especially for consumers located in rural and high cost areas.

It must be obvious, and indeed, Dennis just talked about it, that new entrants will find it difficult to compete with incumbents who, as a matter of social policy, are required to price their residential exchange service product offering below the cost of providing it. Any high cost universal service plan, then, must not stand in the way of the development of balanced competition. A fund too large is inefficient. However, a fund too small will frustrate balanced competition development.

We believe that the Act, as well as sound public policy requires that this implicit subsidy be made explicit. That is, be clearly identified, be shared among service providers in a competitively neutral fashion, and be made available to competing eligible carriers. Failure to do so will, among other things, lead to the erosion of widespread availability of comparable telecommunication services, as well as frustrate the development of a competitive marketplace.

Dealing with this implicit subsidy will, in the final analysis, fall to the state public service commissions. However, as we all recognize, there is a substantial role for the FCC to play in providing support targeted at reducing the overall subsidy problem.

Clearly, Federal access charges implicitly support the cost of local exchange service. Indeed, the Commission's separations process allocates local loop cost of the interstate jurisdiction for recovery by the -- via the subscriber line charge, pixies and the carrier common line charge. This relationship between common line recovery and the support of universal service has been recognized by the Commission since its inception of its access charge structure.

Bell-South's proposal leverages off a statement the Chairman made in the FCC's report to Congress on universal service. The Chairman argued that the state and the Commission should act to preserve existing sources of both implicit and explicit support. We agree.

Our proposed plan, laid out more fully in the record, suggests the creation of a Federal high cost support fund for non-rural companies made up of two pieces. The first piece converts existing explicit support plus the implicit support embodied in pixies and CCL, into explicit support targeted at the higher cost wire centers.

The second piece, which we refer to as the safety net, provides new support for the very high cost wire centers. Both funds operate to relieve state cost burdens. Taken together, these two new mechanisms can be implemented on a revenue neutral basis. Pixies and CCL charges replaced by the explicit fund can be reduced or eliminated, allowing reductions in toll rates.

Safety net support will reduce the need for insupportably large state universal service funds and thus allow more reasonable sharing of universal service obligations in all jurisdictions.

Finally, we suggest that the burden of the new Federal fund be shared among all telecommunication providers operating in the interstate marketplace, via an allocation on one of them, based on each carrier's pro rata share of total retail revenues.

I thank you for your time, and I look forward to your questions.

CHAIRMAN KENNARD: Thank you, Mr. Bush. Mr. Bluhm?

MR. BLUHM: Thank you, Mr. Chairman, members of the Commission and members of the Joint Board. I'm Peter Bluhm, Policy Director for the Vermont Public Service Board. With me today is Joel Shiffman from the main Public Utilities Commission who was the other lead staffperson who was the author of the ad hoc plan. Mr. Shiffman will be available after the break to answer your questions.

I will focus in my remarks this morning on two key tests of the successful universal service plan. The universal service plan must be sufficient, and it must be efficient. Sufficiency means that the system must be -- must allow affordable local telephone rates to be available to subscribers everywhere in the country. Rates do not have to be equal between downtown Los Angles and rural Vermont, but they must be reasonably comparable.

Efficiency is also necessary. Financial resources are limited and regulators cannot federalize all high cost support objectives, including all implicit subsidies that today exist in state rate structures. It is neither economically desirable, nor politically possible to raise 10 or 15 billion dollars through a surcharge on interstate services.

Universal service at the Federal level must make do with a smaller budget. And it should limit its objectives to supporting the areas that are most closely connected with the objectives of the Act.

The current system fails to meet these standards. First, because it is insufficient. It does even pretend to support all rural and high cost areas equally. It discriminates against rural areas that are served by large companies.

Vermont is, by one definition, the most rural state in the country, and yet, we have a major carrier who serves 85 percent of our customers. Customers who live in this area receive substantially less support today for high cost loops in switching than do customers in other equally rural areas. Furthermore, the current program totally ignores the high interoffice trunking costs in many rural states.

The current system also fails to comply with the Act because, by basing support in part on the size of the incumbent, the current system is incompatible with competition. Competition requires that subsidies be made explicit and portable. A support system that links the amount of support available in an area to the identity or size of the incumbent clearly would destroy any effort to achieve meaningful affordability.

The Commission's order of May 1997 establishing the 25/75 split, likewise fails to test its sufficiency. The text of the rule itself actually moves away from sufficient by, in effect, repealing high cost support for the state jurisdiction. Even if current support levels were maintained to the state jurisdiction, however, the 25/75 plan remains insufficient. Indeed, even if the Commission were to apply the full 25 percent support entirely to the state jurisdiction, the result still would not be sufficient to insure that customers everywhere in the country have reasonably comparable rates.

Simply put, some states have low cost urban areas from which they can draw support. Other states have only small or in one case, no real urban areas, and very limited ability to finance high costs. For these states, average costs are so high that it is impossible for them to obtain comparable rates no matter what they do.

In states with many high cost customers and few low cost customers, the surcharges needed to achieve comparable rates would be so large that when they're added to existing rates, the result would no longer be comparable.

These high average cost states face a Hobson's choice. They can either impose very high end user surcharges, thus destroying comparability, or they can impose very high interexchange carrier access charges, thus impeding competition and economic development.

A universal service support system can be both sufficient and efficient. The Commission should set up an overall framework for support. But that framework can anticipate that the states will fill some of the pieces.

While the Act does not require any state to enact a high cost support program, the Commission can appropriately make some assumptions about state effort. The only alternative is raising 8 to 10 billion dollars, something that is politically unacceptable to the Congress, and frankly, something that is not necessary.

A sufficient fund of more modest size, however, requires regulators to be selective about how Federal support will be distributed. If support is given to areas that can raise that support another way, such as in low cost areas that are today inside state borders, there will not be enough funds left over to finance affordable and comparable rates in other states.

The ad hoc plan, which I worked on, limits Federal support to the amount by which a state's costs exceeds the national average. The plan assumes that if a state has average costs that are at or below the national average, the state can support its own high cost areas from within its own borders by surcharging its own low cost areas.

This decision is appropriate since much of the anticipated support is implicit today in rates that are set by state commissions. There is no immediate need to replace these in-state transfers with Federal support.

The ad hoc proposal also uses both forward looking and embedded costs in calculating support. This feature has been controversial, but it serves important purposes --

CHAIRMAN KENNARD: Mr. Bluhm, I am going to have to ask you to sum up.

MR. BLUHM: Thank you, Mr. Chairman. In summary, Mr. Chairman, I appreciate the chance to be here today, and I think you'll find the ad hoc plan provides a sound framework to meet the requirements of the Act. Thank you.

CHAIRMAN KENNARD: Thank you very much. Mr. Wendling?

MR. WENDLING: Yes, thank you, Mr. Chairman, members of the Commission and state members of the Joint Board. My name is Warren Wendling. I'm on the staff of the Colorado Public Utilities Commission.

I'm going to jump right into a couple of specifics of the type of plans that my colleague from Vermont, Mr. Bluhm, was talking about. What happens when a state has relatively high cost and a fairly small revenue pot upon which to develop an intrastate fund?

The two proposals I want to outline in some just overview, are called the variable benchmark and the variable support method.

The variable benchmark is exactly that. It's a building upon the four step process that the Commission had previously adopted using a forward looking economic cost, but then to adjust the benchmark based upon a state's ability to internally generate funds to meet its share of the requirement for high cost fund. For example, a state that has relatively low cost and lots of intrastate revenue might have a Federal benchmark set at $75, while another state with more high costs and less revenue -- intrastate revenues, might have a lower benchmark, say, of $40.

What kind of things would differentiate between these two states? Well, the factor might recognize any number of different things. It could be the ratio of revenues -- intrastate revenues -- the total revenues. The ratio of intrastate traffic volumes if you're concerned about the prices that might be set. It could look at the ratio of the variability of costs among the states. Is there a high very cost area and a very low cost area, or it is uniform?

The factor might recognize the degree of number of lines located in urban or rural areas. It could be the ability of the state to keep local rates low or within a reasonable range, or it could even incorporate a measure of local competition.

The factor could be a combination of those factors. It doesn't have to be any one of those, but any one of those or in combination with several could produce the result of a reasonable size fund that still could be supported within states that have very high costs and low revenues.

I have not provided any specifics about dollars of what this would be or how exactly it would work. I think several of the commentators have mentioned one of the first steps we need to have is a Commission-adopted model with a set of inputs that then could be tested. I think it was the Laska comments that said, "Be sure and test what you propose carefully before we adopt it." And I think that's advice well given.

Another option that builds upon that, instead of varying the benchmark, if somehow the benchmark has with it, the baggage that that is an affordable benchmark. One could adopt a single benchmark and than just look specifically, to varying the support by state. Adopt a uniform nationwide 31 residential/51 business benchmark, but vary the percent from 25 percent interstate upward to address those issues of the state's ability to generate a support internally.

And again, the same kind of factors are the ones that we would have to look at, like the traffic revenue, the ratio of high cost lines to low cost lines, et cetera.

So, I'll be brief, and I think that has come in under my time.

CHAIRMAN KENNARD: Thank you. And we appreciate that. Mr. Brown?

MR. BROWN: Good morning, Mr. Chairman, Commissioners and Joint Board members. My name is Glenn Brown. I'm Executive Director of Public Policy for U.S. West. And I'm here today to describe the interstate high cost affordability plan or IHCAP as we call it.

This plan was developed in an effort to find a workable, middle ground solution to an urgent problem. And that is how to fund continuation of affordable service in high cost rural areas of the "non-rural" LEC's.

And this is a problem not just in the western United States that we serve. It's a problem in many southern states. It's a problem in the New England area. It's a problem in the Appalachian areas.

Let me give you an example using U.S. West figures. In the 14 states that we serve, we serve over half a million customers who cost, in excess of $50 per month. And that's not using our cost studies. That's using the common inputs that the FCC staff developed. And of that total, over 200,000 cost in excess of $100 per month to serve.

Now, several times today, there's been discussion about, how important is January of 1999? We think it's very important for this reason. I've heard people say that the competition that people expected with the Act has not materialized. But I think there, we're applying maybe the right data to the wrong problem, because the competition has not materialized for residential and small business customers, which for the most part, are priced near or below cost.

But when you look at the large business customers, where a majority of the implicit support is derived, there's vibrant competition going on right now. And our very serious concern is that that competition is draining out of the bucket as we speak. And the customers that are going to feel the impact of that first, are these very highest of cost customers. That's why we developed the IHCAP plan.

We had four objectives in mind when we developed it. Number one, it must be simple and understandable. Two, it must leave states with the primary role for rate rebalancing and assuring affordable service to all their citizens. Three, it must address the needs of states that face a problem because of a lot of high cost customers and no large urban areas with low cost customers to spread them over. And it must do so with minimum additions to the Federal fund. And finally, it must be capable of implementation by January 1 of 1999.

The working of the IHCAP plan are shown on Chart 1 in the material that I provided. As you'll see, for costs as derived by a proxy model under $30 per month, there would be no Federal support or no Federal explicit support. Between $30 and $50, we keep the same 25/75 in the original plan. And then, over $50 per month, the costs would be funded from the Federal fund.

Now, if you look at Chart 2 that I've provided, I've shown, using as a representative cross-section the states represented by the Joint Board Commissioners, the impact of the two plans, the 25/75, the solid line that you see on that chart is the impact stated as a surcharge on intrastate rates of covering 75 percent of that state's high cost need. Again, using the staff's common inputs.

The cross-hatched or red line shows what happens when you take the over $50 customer out of the mix. And I find with this sample, but I also find when I look nationally, that somehow when we take the over $50 customer out of the mix, we bring each state in with a roughly similar problem to solve. And again, I do believe that the fundamental solutions have to occur at the state level.

I agree with Commissioner Wood that we're probably not going to solve the whole universal service in one fell swoop. However, the problems of the very high cost rural customers served by non-rural LEC's are real. They require attention soon. The January 1, 1999 date must be met. I agree with others that have showed that there will be additional implicit support interstate access, and that'll have to be carefully managed as move forward.

Thank you. We think the IHCAP plan is a reasonable first start. And I look forward to your questions later.

CHAIRMAN KENNARD: Thank you, Mr. Brown. Mr. Lubin?

MR. LUBIN: Thank you. My name is Joel Lubin, Regulatory Vice President Public Policy of AT&T. Thank you for giving an opportunity speak before you do on the proposals to revise the methodology for determining high cost support.

AT&T supports the Commission's proposed four step methodology for determining high cost funds. However, the Commission should revise the timing and implementation of that methodology.

First and foremost, the Commission should withhold payment of any high cost support targeted for major, non-rural LEC's regardless of the methodology employed to over $20 billion in aggregate.

In the nine study areas where such revenues fall short of forward looking costs, and even here the shortfall is approximately $200 million in aggregate, these LEC's have additional sources of support including intrastate toll, wireless revenues, Yellow Pages. And this is before they turn to access charges for even one penny of support. Any support explicit further support payments to these LEC's should be canceled until they can show that such payments are necessary.

I'd like to emphasize that our proposal of withholding payments of major non-rural LEC's should apply under the current support methodology, as well. Today, there's approximately $110 million of the current $1.7 billion explicit Federal funds is paid to the major local company.

This amount was determined by a joint Federal state agreement that was developed in a monopoly environment. It is counter to the competitive landscape explicitly anticipated by the Telecommunications Act. Equally as distressing is the fact that major LEC's do not need this money to support universal service, is the use by which it has been used to undermine the competitor purposes of the Act and frustrate the development of local competition. Therefore, these payments should be